In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 971

MAX A. BURDE AND BERTHE C. BURDE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

BERNARD WEISS AND PEGGY S. WEISS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

This case presents the question whether certain royalty payments made to the petitioners by a partnership owned principally by their wives are taxable as ordinary income (as both lower courts held) or as long-term capital gain. Max Burde and Bernard

Weiss (hereafter called the husbands) had been partners in the wholesale drugs, cosmetics and toiletries business since 1940. In April, 1954, they agreed to help Martin Emory develop and promote a bath oil formula which Emory had invented. Each husband received a one-third interest in Emory's formula in return for financing the costs of development, estimated at $12,000. Among other things, the husbands retained a chemist to test the formula. A patent application was filed in February, 1955, and a patent eventually issued. Although they had originally contemplated that the formula would be sold to a large cosmetic manufacturer as soon as it was commercially practical to do so, Emory suggested in January, 1955, that they produce and market the formula themselves. The husbands declined, but their wives, who had substantial experience in the cosmetic industry, were enthusiastic about the idea. A new partnership, owned one-third each by Emory and the two wives was then organized. Emory and the husbands each transferred their one-third interest in the formula to the new partnership for $2,500 plus six percent of net sales after January 1, 1956. For 1958, the taxable year in issue, Emory and the husbands each received $19,484.33 under this agreement. (Pet. App. 3a-5a.)

Both lower courts concluded that these payments were taxable to the husbands as ordinary income rather than as long-term capital gain. Petitioners contend that they are entitled to capital gain treatment because of § 1235 of the Internal Revenue Code of 1954, which, in general, allows long-term capital

gain treatment on a transfer of all substantial rights in a patent, even if the payment is in the form of royalties.[1] There is a statutory exception, however, for transfers to a "related person." 1954 Code § 1235(d). Congress inserted this exception to prevent taxpayers from using § 1235 to convert ordinary income into capital gain by transfering a patent within essentially the same economic group. See H. Rep. No. 1337, 83d Cong., 2d Sess., A280-A281. The instant case turns on whether the transfer of the patent from Emory and the two husbands to a partnership composed of Emory and the two wives constituted a transfer between "related persons" within the meaning of § 1235(d). Both lower courts held that it did. There is no conflict of decisions, the decision of the lower court is correct, and no further review is warranted.

Section 1235(d) defines "related persons" by reference to § 267. That section was designed primarily to disallow certain losses and deductions arising from transactions between related individuals (such as husband and wife), between an individual and a corporation which he or his family controls, and between corporations controlled by the same family group. Section 267 does not, however, deal with transfers from an individual to a partnership which he or his family controls or between partnerships controlled by

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[1] Petitioners conceded below that if § 1235 is inapplicable the lower courts properly held the royalties taxable as ordinary income (Pet. 6a-7a).

the same group. Such transfers involving partnerships are dealt with in § 707(b), which is a part of Subchapter K covering "Partners and Partnerships."

Both lower courts concluded that when Congress defined "related person" in § 1235 by reference to § 267, it could not have intended all transfers to or between controlled partnerships to qualify for capital gain treatment. Congress' expressed reason for inserting § 1235(d) in the Code was to prevent a taxpayer from claiming capital gain on a transfer that did not substantially affect his economic control over the patent. See H. Rep. No. 1337, 83d Cong., 2d Sess., A280-A281. Such a rationale manifestly applies to a transfer to or between controlled partnerships just as much as to a transfer to a related individual or a transfer to or between controlled corporations. Therefore, both lower courts rejected petitioners' argument that a transfer of a patent from an individual to a partnership he controls or between two partnerships controlled by the same group can never be a transfer to a "related person" within the meaning of § 1235(d).

In reaching the conclusion that the transfer here in question was to a "related person" and thus that the petitioners' royalties constituted ordinary income, the lower courts relied upon two slightly different rationales. The Tax Court and Circuit Judge Friendly concurring in the court of appeals' decision concluded that for purposes of applying § 1235(d) a partnership should not be regarded as an entity, but rather as a collection of individuals. Therefore, in the instant case, where Emory, Mr. Burde and Mr. Weiss

transferred a patent to a partnership composed of Emory, Mrs. Burde and Mrs. Weiss, the transaction should be taxed for purposes of § 1235(d) as if Emory had transferred a ⅓ interest in the patent to himself, Mr. Burde had transferred a ⅓ interest to his wife, and Mr. Weiss had transferred a ⅓ interest to his spouse. Section 267 clearly makes such a transaction between husband and wife one between "related persons" within the meaning of § 1235(d). This approach is supported by the legislative history of the 1954 Code. While § 707(a) provides that a partnership will normally be treated as an entity for the purpose of taxing sales of assets to the partnership, the Committee Report expressly states that if, in "applying other provisions of the internal revenue laws" [here § 1235], it "is more appropriate" to consider a "partnership as a collection of individuals" than "as a separate entity," the Commissioner and the courts are free to do so. H. Conf. Rep. No. 2543, 83d Congress, 2d Sess., 59.

The majority of the court of appeals, while selecting a slightly different rationale, reached the same result in the instant case. The court of appeals majority stated that in deciding whether a partnership should be treated as an entity or as a group of individuals for the purpose of applying § 1235(d), a court should look at § 707(b). If § 707(b) applies, the partnership is not to be treated as an entity and the court will apply § 267 to ascertain whether the transfer between individuals constitutes a transfer to a "related person." Both the Tax Court and the

court of appeals had found that the arrangement between Emory and the two husbands to develop the bath oil patent constituted a joint venture; the Code defines the word "partnership" as including a joint venture. 1954 Code § 7701(a)(2). Therefore, the instant transaction fell squarely within § 707(b)(2)(B), which states that any gain recognized on a transfer "between two partnerships in which the same persons [or their families—§ 707(b)(3)] own, directly or indirectly, more than 80 percent of the capital interests or profits interests" shall be taxed as ordinary income. Since the husbands are deemed to own their wives' interests in the transferee partnership, Emory and the husbands own 100% of both the transferor and the transferee partnerships.

The question presented has limited importance, the lower courts reached the correct result, and there is no conflict of decisions. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted,

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